Cooperative Practices - What's Your Position

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1. Who Should Run the Cooperative - The Board of Directors or Management?

The board of directors is the policy-determining body of the corporation and it is also the only body which can authorize transactions. Cooperative board members are farmers and their farming operations require much of their time. How much of the board's authority should they delegate to their manager?

What is your position and why?

The Board of Directors is charged with the responsibility for exercising all the authority of the corporation, its management, the safeguarding of the cooperative's assets and the conduct of its business -- and the Board is the only group of persons in whom this authority is vested.

The Board of Directors is the governing body of a corporation legally created under state statutes and issued a "charter". The state statutes give the Board authority to exercise all the powers of the corporation limited only by any conditions set forth in the chartering states statute and the corporation's Bylaws.

The directors of cooperatives are charged with the management of the total corporation and are responsible for the acts of the principle executive officers of the corporation. While the Board of Directors is charged by law with the responsibility of managing the affairs of a business, this responsibility should not be interpreted as meaning the Board should manage the day-to-day operating details of the cooperative. The day-to-day management should be delegated to a competent general manager who is held accountable by the Board for his decisions and performance. The Board is responsible for directing the manager in conducting the cooperative affairs.

Due to the uniqueness of the responsibilities of the cooperative director, the cooperative manager will usually assume responsibilities not assumed by managers of other types of business. Directors are usually full time farmers and do not have the time or staff of a professional director. The cooperative manager must, if agreeable with the board members, do much of the research, figuring and writing to prepare board members to discharge their responsibilities with dispatch. The Board of Directors can delegate all operational responsibility and authority to a general manager, but the Board of Directors retains the accountability.

2. Should a Regional Cooperative Be Centralized or Federated?

In a federated system, the farmers' local cooperative joins with other cooperatives to organize and own another cooperative with each of the farmer's local cooperative being a member of the federated cooperative. In a centralized cooperative, farmers are members of the centralized and are not members or direct owners of the local cooperative that may serve them.

Which type of regional do you favor and why?

The federated cooperative is often referred to as a "grass roots" type organization because individual farmers are owners and members of a local cooperative that in turn owns the regional.

In a centralized cooperative, farmers are members of the centralized and are not members or direct owners of the local cooperative that may serve them.

Among the advantages of the federated type are:

-- A greater involvement of farmers in the control and management of the local cooperative that serves them.

-- A local cooperative that owns a federated will return to its local farmers-owners the profits from their own cooperative operation plus its share of the federated's earnings.

-- Farmers will recognize the need to provide adequate financing and commitment for their cooperative to be successful.

-- Farmers elect the directors to manage their local cooperative.

-- Directors of their local cooperative live closer to the individual member.

Among the advantages of the centralized type are:

-- Locals obtain all supplies and market all products through the centralized thus assuring volume and quality control.

-- Management of locals is not under direct pressure of local members.

-- Management and marketing decisions can be made quickly.

-- Management has more opportunity to advance within the cooperative.

-- All members of the centralized share equitably in the patronage refunds of the total cooperative system.

-- There is less director and annual meeting expense.

-- Prices are essentially the same at all branches.[3/]

3. <u>How Big Should Agricultural Cooperatives Be - Should Their Size be Limited to Locals or Regionals or Interregionals</u>?

There are those who feel that the purpose or intent of agricultural cooperatives can best be met by local cooperatives. Some have proposed that cooperative size be limited to relatively small geographical areas served so all members can be involved in management of the firm. Some have proposed limiting size by establishing dollar volume. Some point out the advantage of size and propose the ideal organizational size to be regional, either centralized or federated.

What is your position and why?

The size of a cooperative should be determined by the competitive and economic climate it operates in. Cooperatives may need to expand into basic products, or processing to obtain a steady economical supply of imputs or to expand in geographic size to maximize the economies of marketing and distribution. There will be situations where local cooperatives will be the desirable solution; however, in some marketing and supply situations local cooperatives may function only as a collection or distribution center operating for the primary benefit of non-cooperative agribusiness. The deciding factor as to size should be for cooperatives to seek that size which permits it to best serve its farmer owners.

The historical development of agricultural cooperatives in the United States for the most part has been farmers organizing local cooperatives to supply a need or service. Local cooperatives have joined together to form regionals in their effort to secure a dependable and economic source of supplies or market outlet. Regionals have joined together to form interregionals to provide an economic unit to compete effectively and economically to obtain supplies and market products.

[3/] Cooperative Structure, ESO 548, Department of Agricultural Economics and Rural Sociology, The College of Agriculture, The Ohio State University, Columbus, Ohio.

4. Should Patronage Refunds be Paid to Non-members as well as Members of the Cooperative?

A basic principle of cooperatives is operations at cost. This means that margins earned by the cooperative firm are over charges for items sold or underpayments for items marketed for patrons. Should those individuals who, for whatever reason, are not member-owners of the cooperative receive patronage refunds on the business they do with the cooperative?

What is your position and why?

A member has a permanent interest and voting rights in the cooperative. A non-member patron is anyone who does business with the cooperative. Most cooperatives are, under the law, free to transact business with members and non-members. Limitations on non-member business are found in The Capper Volstead Act, The Agricultural Marketing Act, Section 521 and others. A cooperative that qualifies and operates under Section 521 of the Internal Revenue Code must treat all members and non-member patrons alike in all respects, including patronage refunds.

If margins derived from business with non-member patrons are distributed to member patrons, such allocations do not qualify for deductions as patronage dividends for IRS taxing purposes. Only patronage refunds paid patrons "on a patronage basis" are deductible from taxable income.

The point is made that the cooperative should operate for the mutual benefit of members who have committed themselves and their capital to their cooperative. Some patrons of the cooperative may, because of laws, Bylaws, or policies, not be eligible for membership in the cooperative; however, they do patronize the cooperative. The profitability of the cooperative may be enhanced by the patronage obtained from non-members regardless of how they are treated in respect to patronage if the increased marketing or supply volume improves the cooperative's market power.

Some cooperatives may discover that by extending patronage privileges to non-members there is less incentive for non-members to become members and financing the cooperative. Some cooperatives' Bylaws provide that the patronage allocations to non-members eligible for membership shall be applied first toward the purchase of a membership in the cooperative.

The board may need to analyse the situation carefully to determine the economic impact of either choice on the operation of the cooperative. The choice should be determined by which practice is most positive to the economic welfare of the cooperative.

5. <u>Should the Evidence of Membership in the Cooperative be a Share of Stock or a Membership Card</u>?

This question can influence the financial structure of the cooperative. The issue is <u>not</u>: Should the financial structure of the cooperative be stock or non-stock. The issue is: Which practice do you believe best serves the purpose of farmers and their cooperative, and why.

A member of a cooperative is one who has an equity interest in the cooperative and is entitled to voting privileges.

Membership in a non-stock cooperative is evidenced by a card or certificate of membership and is usually not transferrable. Membership in a stock cooperative is evidenced by a share of voting stock, usually a share of common stock.

The membership evidenced by a share of stock may be more visable and meaningful to members. In either case, the membership in the cooperative can be earned and of a large or small dollar value. Under some state statutes, the stock membership can have an economic advantage at the time of dissolution as only current members of a membership cooperative may share in the resulting proceeds at the time of dissolution. A share of capital stock of a cooperative represents the interest or right which the owner has in its surplus profits at dissolution. Some state statutes specify that members of a membership cooperative can have only one vote thus preventing the opportunity for allocating votes on the basis of use made of the cooperative. The possession of a share of stock or membership card or certificate of membership is not evidence of the cooperative's indebtedness to the holder but is evidence of ownership.

6. <u>Should a Marketing and/or Purchasing Cooperative Elect to Qualify for Section 521 of the IRS Code (sometimes called exempt)</u>?

Marketing and/or purchasing cooperatives that meet certain requirements may apply for "exempt" status or 521 classification. Should an eligible cooperative apply for exempt status? Support your position.

Neither of these terms means that the cooperative is "exempt" from IRS taxation or any other tax. An agricultural marketing or purchasing cooperative that applies for, meets the qualifications and is granted 521 status is often referred to as "Exempt". To qualify for 521 status, a firm must be: farmers, fruit growers or like an association organized and operated on a cooperative basis. A marketing and/or purchasing cooperative ultimately turning back all net proceeds to members and non-members alike, may be stock or non-stock and pay no more than 8% interest on stock. Substantially all voting stock must be held by producers who use the cooperative. The value of products marketed by a 521 or "exempt" cooperative for non-members must not exceed the value marketed for members and the value of supplies purchased for persons who are neither members or producers must not exceed 15% of the value of all the cooperatives purchases. If a cooperative can qualify, there are two important questions: 1. Is the cooperative primarily financed with Equity Capital, and 2. Does the cooperative pay interest on Equity Capital. If the answer to these questions is "No" then there is no real value to assuming the constrains of Section 521.

An "exempt" or 521 cooperative files an IRS Form 990C and is allowed a tax deduction of interest paid on equity capital. A "non-exempt" cooperative files an IRS Form 1120 and is permitted patronage deduction only for income related to patronage.

An "exempt" or 521 cooperative with a 48% IRS tax rate that pays $10,000 annual interest on equity capital would need only a $10,000 cash flow; however the same cooperative with a non-exempt classification with a 48% tax rate and paying $10,000 interest on equity capital would require a cash flow of $19,230 ($9,230 for IRS taxes and $10,000 for the interest on Equity).

7. <u>Should a Cooperative be Financed with a Majority of Equity or Debt Capital</u>?

Debt capital is that capital with a due date.

Equity capital is funds invested in the cooperative by members. Equity funds may be in the form of stock, membership fees, revolving fund credits, etc., without a due date. An evidence of ownership of equity capital such as a share of stock or membership certificate is not evidence of indebtedness of the cooperative to the holder but is evidence of ownership.

Debt capital has a due date and evidence of ownership of debt capital is evidence of debt by the firm to the holder. Interest paid by the cooperative to holders of debt capital is a tax deductible item in the year paid.

Those cooperatives that qualify for Section 521 can deduct interest paid on equity capital from their taxable income.

Equity capital does facilitate the cooperative's ability to secure debt capital.

To reach a decision on this issue, one should examine the past financial history of the cooperative to determine the marketability of equity capital.

Is interest paid on equity capital? If interest is paid on equity capital the maximum amount is 8%, however, there is no limit on the amount of interest that can be paid on debt capital.

Are the members of the board willing to call on the membership of the cooperative to invest in their cooperative? As a rule, debt capital is secured with less effort than equity capital.

8. <u>Should the Membership of a Cooperative be Open to All or Limited in Some Way</u>?

This issue should not be confused with a commonly referred to "member only cooperative" which refers to the allocation of patronage under IRS 521. Limited or closed membership cooperatives in this issue refer to those cooperatives that may limit the number of members or the total volume of business the cooperative will receive.

What is your position and why?

A cooperative may select some into membership and reject others. Cooperatives can adopt rules and Bylaws to establish the eligibility of membership.

Some cooperatives find it advisable to limit membership to those who they can adequately serve or to those who produce a prescribed quality or quantity of products. Other cooperatives find that for their type of operation an open membership policy is more practical as new members and increased volume can facilitate growth.

Membership is most often closed in those cooperatives that find that a certain maximum volume of business is most desirable for the successful operation of the cooperative. Some cooperatives limit their membership to those who reside or produce in a prescribed geographic area.

9. Should a Cooperative Price With a Margin or at Cost of Product Handled?

A cooperative that operates with a pricing margin would price its goods and services competitively and return to the patrons any excess margins. A cooperative could also operate by charging patrons a price that would cover most costs and at the close of the business year or other selected period, all costs of operations would be pooled and allocated to patrons as a final cost of goods and services.

What is your position and why?

The common practice of cooperatives today is to price at competitive prices or prices that will yield a margin at the close of the business year. The excess of marketing or selling proceeds over costs of operation are returned to the patron as a patronage refund. The patron takes his patronage refund into his income and pays taxes on it. This theory has been termed the "price adjustment" theory.

A cooperative can charge the member a price calculated to cover all or nearly all costs and at the close of the cooperative's fiscal year allocate the losses of the cooperative on a patronage basis. This practice would find favor with those members who under the existing patronage refund arrangement find that the patronage they now receive from their cooperative elevates their adjusted gross income to a higher rate of taxation. The allocation of costs method would have the effect of reducing the members adjusted gross income and lowering his IRS tax rate.

If patronage refunds were to be ruled as securities by the government and required to be registered, the cost allocation method of price would have a very pronounced economic advantage.

The major disadvantage of the concept is the collectability of the allocated costs.

10. Should the Membership of a Cooperative be Free and Easy?

Should prospective members of a cooperative be required to make a substantial cash investment in the cooperative and meet certain requirements in order to become a member? Should the membership fee to become a cooperative member be just doing some business with the cooperative? What is your position and why?

In a cooperative the benefits to owners occur primarily because they use the cooperative. The success and benefits attained by a cooperative for its members is directly related to the use the members make of their cooperative.

Members of a cooperative should each provide their share of the financing, patronizing the cooperative, electing capable directors, and be involved in the operation of their cooperative. It is advocated that if membership in the cooperative required a significant financial commitment or commitment of patronage, member patronage and involvement could be maximized.

It can also be pointed out that there may be those who for some reason could not meet the financial commitment if it is too high.

The trend appears to be away from free and easy membership in agricultural cooperatives. In the past, there were many cooperatives whose only requirement for membership was to do business with the cooperative.

11. Should the Cooperative be Financed With Permanent or Revolving Equity Capital?

The basic question is should the cooperative be financed by its current patrons or equity capital that was furnished by persons who may no longer be patrons? What is your position and why?

Significant differences exist between investor oriented corporations and cooperative corporations in regrad to financing. Cooperative corporations are obligated to return to its patrons excess costs on a patronage basis. The distribution of the firm's net margins to users rather than investors is on the "price adjustment" theory.

In an investor oriented corporation its owners are investors who generally have no other business relationship with the corporation.

A patron doing business with his cooperative is in reality doing business with himself. Thus, current patrons are encouraged to provide the equity necessary for the operation of their cooperative.

Cooperatives have a unique method for members to finance their cooperatives. Under a pre-existing obligation, the cooperative will allocate a portion of a patron's patronage refund in a non-cash form. Non-cash patronage can be in the form of stock, book equities, revolving fund capital, capital credits, capital certificates, etc. The non-cash patronage allocation must be credited to the patron from whom they were retained. Certificates may or may not be issued. The non-cash patronage may or may not be interest bearing. It is the responsibility of the board of directors to determine the portion of patronage allocated in non-cash form as long as it does not exceed 80% of the total allocated patronage.

It is the board's responsibility to establish a redemption policy for non-cash patronage.

Many believe that a sound, fair redemption policy can build loyalty for the cooperative among current members. Based on the concept that the cooperative should be financed by current members, the board should write, publish and follow a policy of redeeming the non-cash patronage refund of those who are no longer using the cooperative.

Some cooperatives use a revolving fund plan to facilitate the concept of current members financing their cooperative. The revolving fund plan provides for the capital furnished by a particular member to bear a direct relation to his patronage and to ultimately be returned to him.

12. What Should be the Percentage of Patronage Refunds Returned to Patrons as Cash?

For most agricultural cooperatives IRS requires that 20% of the cooperative's patronage refund be allocated in cash, to facilitate the patrons paying income tax on the total patronage allocated. Some farmers say that their IRS tax rate is much higher than 20% and therefore the board should allocate a larger percentage of cash patronage, some even propose 100% cash patronage.

What is your position and why?

A patron of an agricultural cooperative must include in his gross income the total amount of any patronage refund which is allocated to him by his cooperative in the taxable year of allocation. An agricultural cooperative must pay at least 20% of the total patronage refund to the patron in money or "qualified check". The board of directors may at its discretion pay any amount in excess of 20%. The 20% rate was established as a typical IRS tax rate for farmers.

The board decision should be based on the financial condition of the cooperative and its cash flow. Cooperatives that are in sound financial condition and those whose members provide adequate equity capital may be in a position to pay more than 20% as the cash portion of the patronage refund.

The directors of an agricultural cooperative are responsible for protecting the financial welfare of the firm. This issue must be decided on an individual case.

Some cooperatives such as REC's are not required by IRS to pay any cash patronage refund, but may allocate the total patronage refund in a non-cash "capital credit".

13. Qualified or Non-qualified Patronage Allocations.

Should the cooperative actually transfer the ownership of the funds distributed as patronage refunds to the patrons or notify the patrons that they have been allocated funds that the cooperative holds. A qualified written notice of allocation is a factual transfer of ownership. Which, in your opinion, is the best way for a cooperative to allocate the non-cash portion of a patron's patronage refund and why?

For a patronage refund to be "qualified" a cooperative must pay 20% of the refund in money or a qualified check. In addition, the patron must either have the opportunity to draw down the total refund in cash within 90 days after allocation is made or consent in one of three ways to have the refund treated as constructively distributed to him and reinvested by him in the cooperative.[1/]

A cooperative may deduct from its taxable income the amount of qualified patronage allocations accepted by patrons. A patron must include in his taxable income, the year in which it is receive, the total amount (cash and non-cash) of qualified patronage allocation received from a cooperative. The qualified patronage allocation is tax free to the patron at time of redemption as it was taxed in the year of allocation.

A cooperative can not deduct "non-qualified"patronage allocations from its taxable income in the tax year of allocation. The cooperative can make 100% of a non-qualified allocation in non-cash. The patron does not take non-qualified patronage into his taxable income the year it is allocated. The patron does include the amount of non-qualified patronage allocations into his taxable income for IRS taxation in the year it is redeemed by the cooperative. The cooperative can receive an IRS tax deduction in the year the non-qualified patronage is redeemed by the cooperative in cash or certain other payment. (The cooperative paid IRS taxes on non-qualified patronage in the year of allocation).

A qualified allocation that is not cashed by the patron within 90 days of the close of the cooperative's business year becomes a non-qualified allocation.

14. Federal Versus State Charter Cooperative.

Society established certain criteria that firms must meet before permitting them to incorporate. The granting of a charter is the actual incorporation of a firm. Some cooperatives have charters issued by the federal government, others have charters issued by state governments. Which government agency would you prefer charter a cooperative and why?

This issue is one over which we have little control. For the most part, the right for a firm to incorporate is conferred by states, thus most of our cooperatives have state charters. The federal government has enacted certain legislation that permits the incorporation of certain cooperatives, such as Banks for Cooperatives, Federal Land Bank Association, Production Credit Associations, and Federal Savings and Loan Associations.

[1/] Legal Phases of Farmer Cooperatives. Information 100, Farmer Cooperative Service, USDA, page 435.

Directors of agricultural cooperatives must know the origin of the charter given their cooperative and be knowledgeable of the statute authorizing the formation of the cooperative.

15. Should the Objective of the Cooperative be to Earn Profit or Provide a Service?

Why?

At issue here is the objective or purpose of the cooperative, to provide a service or to operate with a margin and return the margin to the patron as a patronage refund. Too often those cooperatives that have service as their main purpose fail to recognize the costs of service and thus fail to generate sufficient cash flow to maintain the cooperative in a healthy financial position. Cooperatives are businesses operating in a competitive economy and must generate sufficient income to cover all costs, including those costs for services provided members. When the prices charged by cooperatives increase above their competitors, too often members are attracted by price to the competitors and give up the service being offered by their cooperatives.

It is a responsibility of the board of directors to establish the cooperative's objective and communicate it to members, employees and the public.

16. Should the Voting Rights in a Cooperative be One Vote per Member or Determined by the Amount of Business a Member Does With His Cooperative?

Why?

The Bylaws and code of regulation of the cooperative will designate within the limits of the state statute under which the cooperative is chartered the number of voting shares one member may own. Kentucky law permits one member of the cooperative to have up to 49 percent of the controlling votes. Most state cooperative statutes permit only one vote per member and in some states no more than five percent of the total vote may be based on volume. One of the dangers of volume voting under a statute such as Kentucky's is that while the cooperative principles of democratic control does not change, the firm can. Two large producers could each have 49% of the controlling votes, or between them have 98% of the controlling votes while the other one hundred or so members have the remaining 2% of the votes.

Some farm organizations use volume voting in the cooperatives they have sponsored.

The concept of volume voting appears to be an advantage in those cooperatives that require investment in the cooperative to be related to volume and appears to work in those states whose statutes limit the total amount of control one member may have to a percentage of 5% of the total or less.

It must be recognized that the principle of democratic control is also met in those cooperatives that permit members to give their proxies to others. This is observed often in Federal Savings and Loan Associations and other cooperatives when new members are encouraged to give their proxies to an officer of the cooperative.

17. <u>In What Order of Priority Should the Cash Flow of the Cooperative be Used: 1. To Pay Dividends on Members' Capital Investment; 2. To Redeem Old Non-cash Patronage; or 3. To Pay Patronage Refunds?</u>

What is your position and why?

Should the patron owner of the cooperative receive interest on his equity investment in the cooperative? The investment in a cooperative is similar to his investment in a tractor or any other tool of modern agriculture. He finances his cooperative to extend his farming operation and, therefor, his return on the equity he owns in the cooperative is from his use of the cooperative. If his cooperative had a 521 classification it would require a cash flow of $10,000 to pay $10,000 stock dividends. If the cooperative did not qualify under 521, the stock dividend would not be deductible from taxable income and if the cooperative's IRS tax rate was 48%, a cash flow of $19,230 would be required to pay the same $10,000 stock dividend. Assuming the patronage refund qualified for deduction from the cooperative's taxable income, in most cases it would be to the farmer owners benefit for the cooperative not to pay a stock dividend but to use available funds to pay a patronage refund. The stock dividend and the patronage refund are both to be taken into the farmers income and taxed at the farmers income rate.

There are many advantages to a sound redemption policy. In addition to keeping the financing of the cooperative in the hands of current users, it places value on non-cash patronage.

Some farmers report that the 20% cash portion of their patronage refund is too small. An increase in the percentage of the cash portion of the patronage refund might also encourage more patronage.

The cash flow can be spent but once and the allocation of it is a responsibility of the directors. Each board must make its own decision based on its individual situation.